NO. 80-941

MAR 1981

IN THE
SUPREME COURT OF
THE UNITED STATES

OCTOBER TERM, 1980

LOMAS & NETTLETON FINANCIAL
CORPORATION et al.,

Petitioners,

v.

GEARLD CLARK et al.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

PETITIONERS' REPLY

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PETITIONERS' REPLY

Petitioners stated in their petition that: (1) the decision of the United States Court of Appeals for the Fifth Circuit conflicts with prior decisions of this Court and other courts of appeals; (2) the decision of the court of appeals is not supported by Fed.R.Civ.P. 23.1 ("Rule 23.1"); and (3) this case presents important recurring questions of federal law concerning the power of every federal court to approve

settlements of derivative actions brought under the federal securities laws and the deference which federal courts should give to the inherent powers of corporate management.[1/]

REPLY TO RESPONDENTS' POINTS I, II, and IV

1. Respondents contend that the court of appeals' decision does not conflict with this Court's holding in Burks v. Lasker, 441 U.S. 471 (1979), because respondents alleged in the district court and the court of appeals that the board of directors of Booth, Inc. had conflicting interests, could be controlled by defendants, and were incompetent to recommend settlement of the derivative claims. Respondents argue:

> [W]here the directors "stand in a dual relation which prevents an unprejudiced exercise of judgment", the Board's judgment is reviewable. (Respondents' brief in opposition at 12, quoting an unspecified source.)

1/ Pursuant to S.Ct. Rule 28.1, petitioners listed all non-wholly-owned subsidiaries of each corporate petitioner in their petition at i.

However, the question presented to this Court is not whether the judgment or the decision of the board of directors is reviewable. In fact, the district court expressly reviewed the board's proposed settlement.[2/] The district court made explicit findings that the settlement was fair, reasonable, adequate, and in the best interests of the corporation, that the majority of the directors of Booth, Inc. was disinterested, and that "[t]he 'evidence'

2/ The authorities cited by the respondents, Galef v. Alexander, 615 F.2d 51 (2nd Cir. 1980); Maher v. Zapata Corp., 490 F.Supp. 348 (S.D.Tex. 1980); and Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), do not apply. The issue here is not whether the board's decision is reviewable but whether the court of appeals correctly supplanted the board's settlement recommendation and the district court's findings that the board did not have conflicting interests and that the settlement was reasonable and fair with an irrebuttable presumption of incompetency and invalidity.

cited by the Plaintiffs does not support the allegations of conflict of interest."3/

The court of appeals did not find that the district court erred or abused its discretion in making express findings that the directors did not have a conflict of interest. Instead, the court of appeals created an irrebuttable presumption of the incompetency of corporate directors to settle a derivative action where there are allegations of potential conflicts of interest. In holding that the directors were incompetent to recommend settlement of a derivative action, the court of appeals in this case stated:

> In this connection, appellants point out that co-defendant Jack Booth - one of the Old Booth officials joined in 1976 - is president, a director and the largest Booth shareholder. Mr. Booth and LNFC together own a majority of

---

3/ Clark v. Lomas & Nettleton Financial Corp., 79 F.R.D. 641, 649 (N.D.Tex. 1978), rev'd, 625 F.2d 49 (5th Cir. 1980); petition for writ of certiorari at appendix B-16.

Booth's outstanding shares. Booth's charter forbids cumulative voting, and it is undisputed that each and every director who ratified the compromise was elected by Jack Booth's and LNFC's combined vote. A majority of those directors, moreover, were insiders. Jack Booth and LNFC wielded power to strip them not only of directorates, but of officer and consultant positions as well. Nor can we ignore the possibility of "structural bias" in this case, see Note, supra, 65 Cornell L.Rev. at 619-22, suggested by Booth's sudden, hostile reaction to Mr. Booth's joinder.

The district court forthrightly confronted the conflicts question, but in the end did little more than state its conclusion that the new Booth board was disinterested:

> The board of directors of Booth, Inc. that approved the settlement of the derivative action was comprised of different individuals than those who occupied those positions at the time of [the acts complained of] . . . The fact that LNFC and Jack Booth have controlled more than 50% of the stock of Booth, Inc. since May 10, 1973 does not, by itself, establish that the board of directors of Booth, Inc. were unable to make an independent judgment about the settlement proposal. Jack Booth was specifically excluded from the Board meeting and did not vote on the settlement proposal. . . . [T]he majority of the 7 man board of directors of Booth, Inc. was disinterested. Jack Booth, the only defendant on the Board, was excluded from the Board meeting by Booth's lawyer.

Clark v. Lomas & Nettleton Financial Corp., 79 F.R.D. 641, 649-50 (N.D.Tex. 1978). The preceding discussion simply does not address appellants' main point, which is that Jack Booth's and LNFC's combined shareholdings may have influenced the settlement terms. It is irrelevant that Jack Booth did not vote on the compromise proposal as a director; appellants' objection looks to his status as a shareholder. 625 F.2d at 52-53

The court of appeals concluded,

> [B]y a parity of reasoning, that Booth's directors were incompetent themselves to compromise all of appellants' derivative claims.
>
> The board's conflict of interest could not be cured by judicial approval of the settlement terms. 625 F.2d at 54.

The Court of Appeals for the Second Circuit used similar reasoning in its decision in Lasker v. Burks, 567 F.2d 1208 (2nd Cir. 1978), rev'd, 441 U.S. 471 (1979). In Lasker, the court of appeals reversed the district court's order dismissing a derivative suit upon the recommendation of a special litigation committee and minority directors. That circuit court promulgated an absolute rule that minority directors

were incompetent to recommend dismissal of a non-frivolous lawsuit against co-directors, reasoning:

> Moreover, in many instances where no specific authority is granted by statute the courts have inferred that stockholders may bring suit. See e.g., Abrahamson v. Fleschner, 568 F.2d 862 at 873 (2d Cir. Feb. 25, 1977) and cases cited therein. It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their codirectors for liability which may amount to many millions of dollars, and foreclose the stockholders from continuing such litigation, while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter.
>
> In the ordinary routine of running an investment trust, the disinterested directors must constantly deal with interested directors in a spirit of accommodation. Indeed, they are compelled for the most part to rely on the information and expert advice provided by the adviser and the majority directors. The continued service of the statutorily disinterested directors, for which in this case they were paid from $11,000 to $13,000 per annum, depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection. It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an

adverse decision would be likely to result in considerable expense and liability for the individuals concerned. Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. It follows that disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties. 567 F.2d at 1211-12.

This Court, in Burks v. Lasker, 441 U.S. 471, 99 S. Ct. 1831 (1979), reversed, holding:

> Yet, while these potential conflicts may justify some restraints upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser, they hardly justify a flat rule that directors may never terminate nonfrivolous derivative actions involving codirectors. In fact, the evidence is overwhelming that Congress did not intend to require any such absolute rule.
>
> * * *
>
> In short, the structure and purpose of the Investment Company Act indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders. There may well be situations in which the independent

> directors could reasonably believe that the best interests of the shareholders call for a decision not to sue-as, for example, where the costs of litigation to the corporation outweigh any potential recovery. [citations omitted]. In such cases, it would certainly be consistent with the Act to allow the independent directors to terminate a suit, even though not frivolous. Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon "watchdogs" to protect shareholder interests and yet, where the "watchdogs" have done precisely that, require that they be totally muzzled. 99 S.Ct. at 1840-41.

This Court held:

> We hold today that federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the Investment Company and Investment Advisors Acts. Moreover, we hold that Congress did not require that States, or federal courts, absolutely forbid director termination of all nonfrivolous actions. 99 S.Ct. at 1841.

The imposition of the rule adopted by the court of appeals in this case is directly contrary to this Court's ruling in Burks because: (1) it creates an irrebuttable presumption of a board's incompetency to recommend settlement where there is any

alleged potential conflict of interest, a presumption Burks expressly rejected; (2) it dictates the application of federal procedural law rather than state substantive law in determining the power of a board of directors to recommend the settlement of a derivative action to a federal court; (3) it replaces the district court's express findings of fact with an irrebuttable legal presumption of wrongdoing, based solely upon an unsupported possibility that a defendant's shareholdings "may have influenced the settlement terms." 625 F.2d at 52-53.

In short, in Burks this Court held that the Investment Company Act did not preclude directors from terminating derivative actions against their fellow directors. This Court should hold that Rule 23.1, and its procedural requirements, do not proscribe a board of directors from recommending, and a district court from approving,

the compromise of a derivative action merely because claims have been pled against major shareholders of a corporation.

2. Respondents also contend that cases which have considered the "demand" requirements of Rule 23.1 require the holding that, where demand on the board has been procedurally excused, directors are incompetent to recommend settlement of derivative claims.[4/]

However, the determination of whether or not Rule 23.1 requires a shareholder to make a procedural "demand" is unlike the determination of whether corporate directors have the power to recommend that a district court approve the settlement of a derivative suit. The procedural demand requirements

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4/ Here, the district court expressly reserved ruling on the sufficiency of plaintiffs' compliance with the demand requirements of Rule 23.1. Clark v. Lomas & Nettleton Financial Corporation, supra, 79 F.R.D. at 651; petition at appendix B-20.

for prosecuting a derivative action are different from the substantive authority of a board to recommend the approval of a settlement it considers to be in the best interests of the corporation. The "demand" requirement is only a pleading and procedural requirement which does not, and cannot, abridge or modify directors' substantive rights. See 28 U.S.C. § 2072 (1966). The futility or the sufficiency of any demand upon the board to act was not even an issue for decision by the district court in its review of the proposed settlement. Instead, the issue before the district court was whether the proposed settlement was fair, reasonable, adequate and in the best interests of the corporation.

Texas law does not prevent a board of directors from seeking to dismiss, without settlement, a derivative action even where initial "demand" may have been excused. In Murray Savings Association v. Zauber, 601 S.W.2d 940 (Tex. 1980) (per curiam), aff'g

writ ref'd n.r.e., 591 S.W.2d 932 (Tex.Civ.App. - Dallas 1979), the Texas Supreme Court expressly reserved deciding the extent of the directors' power in that instance:

> The summary judgment proof of petitioner Murray Savings Association does not establish as a matter of law that the decision of its board of directors, taken after the suit was filed, to seek to have the case dismissed, constituted the exercise, in good faith and free from improper influence, of the sound business judgment of the board. Accordingly, we do not reach the question of whether such action so taken by the board, if established at trial, would bar the maintenance of this derivative suit even though respondent were to establish good cause for failing, prior to his filing this suit, to make efforts to have the corporation institute the action. 601 S.W.2d at 941.

No Texas or federal law has ever held -- before the circuit court's opinion in this case -- that a finding concerning Rule 23.1's procedural demand requirements prohibits a federal court from approving a settlement of a derivative action proposed by non-defendant directors that is in good faith, fair, reasonable, and in the best

interests of the corporation. The district court properly did not decide or even consider the relevance of the procedural demand requirement of Rule 23.1. Instead, it made substantive findings of fact about the good faith and fairness of the settlement based upon: (1) a well-developed evidentiary record, including extensive discovery into the proposed settlement and evidence at the settlement hearing; and (2) the absence of any objections to the settlement by non-party shareholders.

The court of appeals' opinion nevertheless held, incorrectly and without supporting authority, that the procedural requirements of Rule 23.1 override the substantive rights of a corporate board and a district court to determine the good faith and fairness of a proposed derivative settlement.

3. Respondents also contend that the law firm which represented Booth, Inc. had a

conflict of interest. Contrary to respondents' contention that the corporate counsel had conflicting interests,[5/] the board and its counsel were the only appropriate protectors and representatives of the corporate interest in the face of the respondents' expressed unwillingness to even consider a settlement of the derivative claims without a settlement of their individual claims. As the district court observed:

> I can conceive that if this settlement was rejected that such a conflict [between plaintiffs' derivative claims and their individual claims] might arise later in these proceedings, and I did observe that the Plaintiffs refused to even consider settlement of the derivative case apart from the individual claims. Transcript of Proceedings,

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5/ Respondents' brief in opposition, Point IV at 25; the court of appeals did not address this contention or the other issues now raised by respondents. These issues are not before this Court in its review of the Court of Appeals' decision. Moreover, these ancillary issues neither control nor affect the court of appeals' holding below and were, in any event, properly decided in the district court. See 79 F.R.D. at 648, 652, 657.

June 5, 1978, pp. 70-71. (emphasis added) 79 F.R.D. at 652.

When the respondents were not prepared to evaluate, or even to consider, any settlement of the derivative claims on behalf of Booth, Inc. in the district court, the corporate directors were obligated to do so. See G. A. Enterprises v. Leisure Living Communities, 517 F.2d 24, 26 (1st Cir. 1975); Robinson v. Computer Servicenters, Inc., 75 F.R.D. 637, 643 (N.D.Ala. 1976).

After these proceedings, the district court properly denied respondents' January 11, 1978 motion to disqualify counsel for Booth, Inc., finding that:

> [Although] technically Tim Kirk did not withdraw from representation of the individual directors until December 22, 1977, my concern is with the actual representation that occurred in this case and I find Tim Kirk did not actually represent the individual defendants for any period of time that would require disqualification.
>
> I also note that Tim Kirk's alleged dual conflicting representation did not concern the Plaintiffs until after the settlement, to which they objected, was negotiated between Booth, Inc. and the

> Defendants. Only then, on January 11, 1978, did the Plaintiffs bring the matter to the attention of the court. I have found no conflict of interest warranting disqualification, but had I believed then or on January 11, 1978 that a conflict existed, I would hesitate to disqualify the Saner firm on Plaintiffs' untimely motion. From the record I can only conclude that the only reason plaintiffs objected to the participation of the Saner firm in the lawsuit on January 11, 1978, when they could have objected to that representation for nearly a year, was to prevent the Court from approving what I have concluded is a fair, reasonable and adequate settlement.[6/]

REPLY TO RESPONDENTS' POINT III

Respondents argue that the court of appeals' opinion does not contravene the federal policy which gives federal courts the power to approve derivative settlements:

> Petitioners urge this court to place a federal court in the position of substituting its own settlement terms for that of the litigating parties who are intimately aware of all aspects of the litigation. (Respondents' brief at 23)

6/ Clark v. Lomas & Nettleton Financial Corp., 79 F.R.D. at 661; petition at appendix C-6.

However, contrary to this argument, the district court did not impose any settlement upon the parties in this case and petitioners do not advocate a rule which would authorize the district court either to initiate or to impose settlements on unwilling parties. Instead, the district court approved a settlement which was recommended to it by the board of directors of Booth, Inc., and which the district court then independently found to be fair, reasonable, adequate, and in the best interests of the corporation. The court of appeals' decision is contrary to Texas corporate law and federal policy because it absolutely negates the district court's power even to consider or approve a settlement presented to it by the proper corporate authority.

In this case, the district court gave the respondents full opportunity to present evidence that the board was incompetent to recommend settlement or that the settlement

was unfair. No such evidence was ever presented below. Instead, the respondents argued, as they argued in the court of appeals, and in this Court, that potential, completely unsupported conflicts rendered the board incompetent as a matter of law to recommend a settlement to the district court. The court of appeals accepted, and has promulgated, a rule of law that creates an irrebuttable presumption of directors' incompetency to recommend settlement where there are mere allegations of conflicts of interest. In so doing the court of appeals has stripped all district courts of any power to approve a derivative settlement which includes the settlement of claims against large shareholders, despite the district court's finding that a settlement is fair, reasonable, and in the best interests of the corporation.

CONCLUSION

The court of appeals' decision promulgates a rule of law which is based solely upon allegations of potential conflicts and which undermines the authority of every district court, in every shareholders' derivative suit, to make an independent evaluation of proof and to determine the competency of a board of directors to recommend a settlement and to decide whether the settlement is in the best interests of the corporation. A writ of certiorari should issue to the United States Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a true and correct copy of the foregoing petitioners' reply has been mailed, by first-class postage prepaid to all counsel of record at the post office address listed below, this 19th day of March, 1981:

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